competition in a particular market area.

400. In its January 18 Letter, USTA urges the Commission to eliminate the Part 69 waiver requirements for the introduction of new rate elements, to reduce the tariff review period to 21 days for new services whose projected revenues satisfy a de minimis test, and to require new services to be supported only by an incremental cost showing.[779]

401. Bell Atlantic recommends that the Commission remove new services from price cap regulation. Bell Atlantic asserts that most new services are "discretionary" services in that they are not essential to consumers or competitors. Bell Atlantic asserts that consumers can elect not to buy new services, and competitive entry will occur, if prices for such services are set too high.[780]

402. BellSouth recommends that if a LEC establishes that the proposed price for a new service filing equals or exceeds long run incremental cost, the rate should be presumed valid at the conclusion of a 30-day notice period. BellSouth asserts that an upper pricing limit is unnecessary for new services because customers will not subscribe to new services that are priced too high. As an exception to this rule, BellSouth recommends that tariff filings for services mandated by the Commission pursuant to a rulemaking should be supported not only by a long run incremental cost showing, but also by a showing that the proposed rates are just and reasonable.[781]

403. MCI asserts that the upper limit on new service prices must be retained because the LECs' extensive market power would enable them to abuse additional pricing flexibility. MCI contends that the lower limit on new service prices also must be retained to guard against predatory pricing and to ensure that the new services are not being subsidized by existing services. MCI opposes the Commission's suggestion in the Notice that new services should receive less scrutiny when they are first introduced because "[t]his would give the LECs too much initial flexibility and increase the administrative costs of reviewing

---

[779] January 18 Letter, Attachment 2 at 2-3.

[780] Bell Atlantic Comments at 24-26; Bell Atlantic January 18 Comments at 5-6; accord Ameritech Comments at 21-26.

[781] BellSouth Comments at 62-65; BellSouth Reply at 35; see also NYNEX Comments at 44-46 and NYNEX Reply at 25 (recommending a dual approach for new services that is similar to BellSouth's proposal and for similar reasons).

the services."[782]

404. MFS, WilTel, and ICA recommend that the new services test be revised to prevent the LECs from establishing discriminatory or otherwise unreasonable rates.[783] To this end, MFS recommends that the LECs be required to incorporate new services into their price cap index calculations immediately upon becoming effective. Also, MFS recommends that new services that will be placed in the trunking basket (as well as existing services in the trunking basket) should be subject to a "cost consistency test." The cost consistency test would allow LECs to increase or decrease rates for individual rate elements as long as the price-to-cost ratio for each rate element remained within 10 percent of the average ratio for the trunking basket.[784] In a similar vein, WilTel recommends that the Commission adopt a "price indexing" approach to evaluating the prices for new (and existing) services, which would allow LECs to change prices for the more competitive services, but only if the LEC adjusted prices for the less competitive prices in a parallel manner.[785] ICA recommends that the Commission adopt a "price linking" approach to new services whereby the LECs would be required to calculate a second, "surrogate" actual price index for each basket. The surrogate API would reflect the embedded services in the basket and all new services based upon three years forecasted demand. The LECs would be required to reduce the PCI for the basket by the difference between the actual API and the surrogate API for the basket when the differential exceeded two percentage points.[786]

405. GTE maintains that WilTel's price indexing and ICA's price linking proposals would make it unattractive for the LECs to respond to demand or cost changes, and to competitive

---

782 MCI Comments at 56; <u>see also</u> ICA Comments at 20; MFS Comments at 28.

783 WilTel Comments at 21-25; MFS Comments at 25-26; ICA Comments, Attachment B at 1. WilTel, MFS and Sprint contend that the plethora of new service offerings over the past three years belie arguments that the LECs lack incentive to deploy new services. <u>Id</u>.; Sprint Comments at 2; <u>see also</u> TAG Comments at 11-12.

784 MFS Comments at 16-17, 26. MFS's cost consistency test would replace the service categories and subindexes in the trunking basket. <u>Id</u>.

785 <u>See</u> WilTel Comments at 27.

786 ICA Comments at 21 and Appendix B at 1.

challenges.[787] USTA states that ICA's proposal to tie one set of prices (i.e., those for new services) to another set of prices (i.e., those for existing services) is inconsistent with a fundamental feature of price cap regulation -- to allow rates to be established independently of other rates, subject to basket and banding requirements.[788]

C. Analysis

406. As we proceed to refine the LEC price caps regulatory scheme, we intend that it will advance the goal of fostering an efficiently competitive local market. We are prepared to modify our regulatory framework if doing so would hasten the emergence of competition. As we have shown in the Interexchange Proceeding and the Performance Review Proceeding with respect to AT&T, we are willing to remove services from price caps and place them under streamlined regulation when the record indicates that the services are in fact subject to competition.[789] We have also demonstrated, in acting upon the Rochester Open Market Plan, our willingness to act on waiver petitions that seek relief from existing Part 61 and Part 69 rules in order to implement their proposals for promoting competition.[790]

407. The present record requires further development to permit us to identify when interstate access services are adequately competitive to trigger the streamlining that we believe is warranted when competition is present. The record also contains insufficient data concerning the competitiveness of specific markets upon which to base a decision to revise our price cap system. This Report and Order, therefore, focuses on the baseline issues identified in the Notice. The further notice in this proceeding will solicit comment on transition issues related to anticipated changes in the market, technology, and regulation over the next few years. We will use the further notice to develop specific standards for evaluating the state of competition in particular markets. The analytical framework we applied to determine which of AT&T's services should be subject

---

787 GTE Reply at 86-87; accord BellSouth Reply at 13.

788 USTA Reply at 44.

789 Competition in the Interstate Interexchange Marketplace, 6 FCC Rcd 5880 (1991) (Interexchange Order); Second Report and Order, 8 FCC Rcd 3668 (1993); Revisions to Price Cap Rules for AT&T Corp., CC Docket No. 93-197, FCC No. 95-18 (released Jan. 12, 1995) (AT&T Performance Review Order).

790 See Rochester Telephone Corp. Petition for Waivers to Implement its Open Market Plan, FCC 95-96 (released Mar. 7, 1995) (Rochester Telephone Corp. Order).

to streamlined regulation may prove applicable to comparable LEC services. Bell Atlantic and Ameritech, for example, claim that their interstate intraLATA toll and corridor interexchange services already compete with offerings from other carriers and should be removed from price caps. If the standards we applied to AT&T prove to be appropriate for assessing the validity of these claims and the record demonstrates that the LEC toll services satisfy those standards, we are prepared to convert those services to streamlined regulation. In addition, knowledgeable parties may advise us that other tools are more appropriate to evaluate the competitiveness of particular local markets. We applaud efforts by USTA,[791] NYNEX, Sprint and other parties that have submitted proposals for adapting price caps regulation to the emergence of competition. These parties recognize, however, the need for a more complete and detailed record regarding the standards for measuring competitiveness of markets.[792]

408. We conclude that the record does contain sufficient evidence to justify allowing the LECs greater flexibility to lower prices within service category bands. This will permit LECs and other carriers to implement rate reductions that will move their prices to more economically efficient levels.[793] We find that an expansion of lower-band pricing flexibility would be in the public interest. The further notice will investigate the conditions that might warrant further relaxation of the lower bands.

409. Parties have objected to the LECs' request for expanded authority to lower their prices on the grounds that such changes may increase the risk of predation, that any departure from fully distributed cost pricing amounts to unreasonable discrimination, and that LECs may abuse prematurely-granted downward pricing flexibility to foreclose competitive entry. We do not believe that a limited increase in downward pricing flexibility would significantly increase the risk of successful predation by the LECs. As we concluded in the LEC Price Cap Order, predatory pricing is fairly uncommon, proven cases are rare, and the establishment of price cap baskets "lessens the

---

791 See also GTE Comments passim (supporting USTA's proposal); GTE March 10, 1995 Ex Parte.

792 NYNEX March 3 Proposal at 4.

793 LEC Price Cap Order, 6 FCC Rcd at 6824. As in the LEC Price Cap Order, we do not believe the record supports streamlining of below-band tariff filings, and we will continue to "err on the side of caution." Id.

already unlikely occurrence of predation."[794] Moreover, the increased potential for access competition in light of our adoption of expanded interconnection for special access and switched transport[795] makes it more likely than it was at the time that we adopted the LEC Price Cap Order that price decreases are legitimate responses to competition rather than predatory pricing.

410. Further, we believe that any increased risk of such conduct is outweighed by the benefits that consumers will receive from lower prices. The Commission has other mechanisms, such as the continued requirement that below-band rate reductions be accompanied by cost support, and the formal complaint process pursuant to Section 208, to protect against predatory pricing. In reviewing the LEC price cap rules, the United States Court of Appeals for the District of Columbia Circuit held that "the statutory 'just and reasonable' rate requirement [does not] mandate[] use of fully distributed cost pricing."[796] Finally, we believe that granting the LECs greater downward pricing flexibility should promote, not hamper, the development of competition. Allowing LECs to set their prices at levels closer to economic cost will invite new entry by firms that are at least as productive as the incumbents, which is the condition for economically efficient entry.

411. Accordingly, we modify the lower bands that apply to the service categories within the traffic sensitive and trunking

---

[794] Id. As discussed above, by grouping services facing similar levels of competition into baskets, we limit opportunities for LECs to engage in predatory pricing by shifting costs to some other less competitive service.

[795] See Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, 7 FCC Rcd 7369 (1992) (Special Access Expanded Interconnection Order); recon. 8 FCC Rcd 127 (1992); second recon., 8 FCC Rcd 7341 (1993); vacated in part and remanded sub nom. Bell Atlantic Telephone Companies v. FCC, 24 F.3d 1441 (D.C. Cir. 1994) (Bell Atlantic v. FCC); on remand Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, 9 FCC Rcd 5154 (1994) (Expanded Interconnection Remand Order); see also Expanded Interconnection with Local Telephone Company Facilities, Second Report and Order and Third Notice of Proposed Rulemaking, CC Docket No. 91-141 Transport Phase I, 8 FCC 7374 (1993) (Switched Transport Expanded Interconnection Order).

[796] See National Rural Telecom Ass'n v. FCC, 988 F.2d 174, 184 (D.C. Cir. 1993)(National Rural Telecom Ass'n); see also id. at 182 ("deviations from fully distributed costs are in certain respects highly desirable and may tend to maximize the consumer welfare created by a regulated natural monopoly").

baskets. We conclude that 10 percent lower pricing bands would give the LECs a reasonable additional amount of downward pricing flexibility, without putting at risk our objectives of preventing predation and cross-subsidization. In addition, we increase the lower pricing bands that apply to density pricing zones from 10 percent to 15 percent, to ensure that LECs continue to have the opportunity to move their rate levels in particular geographic zones toward cost at the same time that they modify the aggregate rate levels in a service category.

412. While we expect to continue to modify the structure of LEC price cap baskets to reflect the introduction of new services and the development of competition, we believe it would be premature on the present record to take further steps in that direction. We are, however, prepared to consider further requests for waivers of our price cap rules to give greater pricing flexibility to individual LECs.[797] We are also willing to consider fundamental modifications such as those proposed by USTA. In either case, we will review such proposals in light of our underlying goal of facilitating the development of competition in local telephone markets.

413. Although USTA and NYNEX have submitted interesting proposals, we have decided to defer to a later phase of this proceeding our consideration of additional streamlining of price cap regulation to reflect broader local competition. With regard to Bell Atlantic and SNET's proposals that video dialtone be removed from price caps, we rejected such arguments in the Video Dialtone Reconsideration Order and we are currently considering whether to establish a separate price cap basket for video dialtone services in the Video Dialtone Further Notice.[798] Neither Bell Atlantic nor SNET have provided sufficient cause to revisit the issue in this order.

414. We agree, as we stated in the Video Dialtone Further Notice, that the rate of development of competition is likely to differ among price cap baskets, and that it will remain important to avoid grouping services with different levels of competition in the same basket.[799] We established baskets originally in part to limit LEC ability to engage in anticompetitive cross-subsidization, that is, from shifting costs from services for

---

797 See e.g., Rochester Telephone Corp. Order.

798 Video Dialtone Reconsideration Order, 10 FCC Rcd at 321-24; Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation, Further Notice of Proposed Rulemaking, CC Docket No. 94-1, FCC 95-49 (released Feb. 15, 1995) (Video Dialtone Further Notice).

799 Notice, 9 FCC Rcd at 1705.

which they face relatively high competition to services for which they face little or no competition.[800] Modifications to price cap baskets and bands may therefore be necessary as competition develops in local telephone markets. As the current record provides neither reliable standards for assessing competitiveness, nor sufficiently detailed information about the state of competition, however, we refrain from altering the composition of price cap baskets at this time.

415. The further notice will also solicit comment on proposals to reduce or streamline the Part 61 notice and cost support requirements for a new service based on the level of competition for that service. Because we plan to examine in the upcoming further notice the proposals submitted by USTA and others suggesting a framework for adapting price cap regulation to the emergence of competition for local services, we will not address the merits of these proposals (including their proposals for relaxing the Part 61 new services rules) in this proceeding.

416. In addition, because we only address the issues identified in the Notice as baseline, we do not address in this proceeding the merits of the proposal suggested by USTA and others that we undertake a comprehensive revision of the Commission's Part 69 rules. The commenters have not convinced us that the instant review of LEC price cap performance is the appropriate forum in which to conduct a review of the Part 69 rules. We note in this regard that substantial revisions to our Part 69 rules likely would affect significantly the interests of LECs that are not subject to the price cap system of regulation. Those carriers have not participated in this proceeding and are entitled to a fair opportunity to be heard on issues that affect them. Therefore, we do not anticipate that our consideration of the transition issues relating to the LEC price cap plan will include a review of the Part 69 rules.

417. The Commission designed the new services rules not only to assure reasonable rates and terms, but also to provide the LECs with the flexibility to price efficiently and the incentive to innovate. In adopting the new services test, the Commission did not intend to imply that the anti-discrimination provisions contained in Section 202(a) of the Communications Act would not apply to evaluating new service pricing. The potential for unreasonable discrimination between a new service and an existing service remains if: (1) the two services are "like" services; (2) the two services are priced differently; and (3) there is no cost justification or other basis to support the

[800] LEC Price Cap Order, 5 FCC Rcd at 6811.

discrimination.[801] The Commission retains the ability to address discrimination issues in the tariff review process, in response to a complaint filed pursuant to Section 208 of the Communications Act, or our own motion under Section 205 of the Act. We therefore find that MFS's cost consistency test, WilTel's price indexing approach, and ICA's price linking approach to the new services rules are not necessary to protect new service customers from unreasonable discrimination.[802]

418. The record in this proceeding does not support a finding that competition for LEC services is sufficiently widespread to constrain the pricing practices of LECs for new services. Accordingly, the Commission will continue to review new services tariff filings for possible discrimination. We will invite parties, however, in the further notice in this proceeding to suggest specific proposals for reducing the regulatory scrutiny afforded particular new LEC services as competition evolves in the marketplace.

VII. REGULATORY FLEXIBILITY ACT ANALYSIS

419. In the Notice in this proceeding, we certified that the Regulatory Flexibility Act of 1980 did not apply to this rule making proceeding, because none of the rule amendments under consideration would have a significant economic impact on a substantial number of small business entities, as defined by Section 601(3) of the Regulatory Flexibility Act. Carriers subject to price cap regulation for local exchange access affected by the rule amendments adopted in this Order are generally large corporations or affiliates of such corporations. Neither the Chief Counsel for Advocacy of the Small Business Administration nor any commenting party challenged our analysis. The Secretary shall send a copy of this Report and Order, including the certification, to the Chief Counsel for Advocacy of the Small Business Administration in accordance with paragraph 605(b) of the Regulatory Flexibility Act. Pub. L. No. 96-354, 94 Stat. 114, 5 U.S.C. § 601 et seq.

VIII. ORDERING CLAUSES

420. Accordingly, IT IS ORDERED, pursuant to authority contained in Sections 4(i), 4(j), 201-205, 303(r), and 403 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 154(i), 154(j), 201-205, 303(r), 403, and Section 553 of Title 5, United

---

801 MCI v. FCC, 842 F.2d 1296 (D.C. Cir. 1988); see also Third Further Reconsideration at para. 8.

802 See also National Rural Telecom Ass'n at 182, 184.

States Code, that Part 61 of the Commission's Rules, 47 C.F.R. Part 61 IS AMENDED as set forth in Appendix B.

421. IT IS FURTHER ORDERED that authority is delegated to the Chief, Common Carrier Bureau, to determine what adjustments are necessary to the price cap indexes, actual price indexes, and service band indexes of local exchange carriers, to account for the effects of the revised effective date of the 1995 annual access filings of local exchange carriers under price cap regulation, and to establish a pleading cycle for review of those tariffs.

422. IT IS FURTHER ORDERED that the provisions in this Report and Order will be effective 30 days after FEDERAL REGISTER publication.

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton

William F. Caton
Acting Secretary

APPENDIX A

A. Parties Filing Comments to the Notice of Proposed Rulemaking

Ad Hoc Telecommunications Users Committee (Ad Hoc)
Aeronautical Radio, Inc. (ARI)
American Library Association (ALA)
Ameritech (Illinois Bell Telephone Company; Indiana Bell Telephone Company, Incorporated; Michigan Bell Telephone Company; The Ohio Bell Telephone Company; and Wisconsin Bell, Inc.)
Association for Local Telecommunications Services (ALTS)
AT&T Corporation (AT&T)
Bell Atlantic Telephone Companies (Bell Atlantic)
BellSouth Telecommunications, Inc. (BellSouth)
California Cable Television Association (CCTA)
Cincinnati Bell Telephone Company (CBT)
Citizens for a Sound Economy Foundation (CSE)
Competitive Telecommunications Association (CompTel)
Computer & Communications Industry Association (CCIA)
Council of Chief State School Officers, and the National Association of Secondary School Principals (Council of Schools)
Eagle Telephonics, Inc., Summa Four, Inc., LC Technologies, Inc., Ambox Incorporated, AmPro Corporation, Axes Technologies, Inc., Teradyne, Inc., Inovonics, Inc., Perception Technology Corp., OK Champion Corporation, Lingo, Inc., Tamaqua Cable Products Corp., Remarque Mfg. Corp., Rhetorex, Inc., Centigram Commun. Corp., HealthTech Services Corporation, American Reliance Inc., Senecom Voice Processing Systems, Technology Service Group, Intelect, Inc., filing jointly (Eagle)
General Services Administration (GSA)
GTE Service Corporation and its affiliated domestic telephone operating companies (GTE)
Intermedia Communications of Florida, Inc. (ICI)
International Communications Association (ICA)
The Lincoln Telephone and Telegraph Company (Lincoln)
MCI Telecommunications Corporation (MCI)
MFS Communications Company, Inc. (MFS)
The National Rural Telecom Association (NRTA)
The National Telephone Cooperative Association (NTCA)
The NYNEX Telephone Companies (NYNEX)
The Office of the Consumers' Counsel, State of Ohio (OCCO)
Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO)
Pacific Bell (Pacific) and Nevada Bell (collectively, Pac Bell)
Pennsylvania Office of Consumer Advocate (PaOCA)
Rochester Telephone Corporation (RTC)
Senior Technologies, Inc. and XTP Systems, Inc., filing jointly (Senior)
Southern New England Telephone Company (SNET)

Southwestern Bell Telephone Company (SWB)
Sprint Corporation (Sprint)
Tele-Communications Association (TCA)
Teleport Communications Group, Inc. (TCG)
Time Warner Communications (Time)
United States Telephone Association (USTA)
US West Communications, Inc. (US West)
WilTel, Inc. (WilTel)

B. Parties Filing Replies to the Notice of Proposed Rulemaking

Ad Hoc
American Library Association, The Council of Chief State School Officers, The National Association of Secondary School Principals, National Education Association, and National School Boards Association, filing jointly (Educational Organizations)
American Petroleum Institute (API)
Ameritech
ALTS
AT&T
Bell Atlantic
BellSouth
BroadBand Technologies, Inc. (BroadBand)
CCIA
CCTA
CompTel
Cox Enterprises, Inc. (Cox)
CSE
GSA
GTE
Hyperion Telecommunications, Inc. (Hyperion)
International Communications Association (ICA)
Lincoln
MCI
MFS
National Association of Development Organizations (NADO)
Northern Telecom Inc. (NTI)
NYNEX
OCCO
OPASTCO
Pac Bell
Pacific Telecom, Inc. (PTI)
RTC
SNET
Sprint
State of Hawaii (Hawaii)
SWB
TCA
TCG
Time
USTA
US West
WilTel

APPENDIX B

Part 61 of Title 47 of the Code of Federal Regulations is amended as follows:

PART 61 -- TARIFFS

1. The authority citation continues to read as follows:

Authority: Secs. 1, 4(i), 4(j), 201-205, and 403 of the Communications Act of 1934, as amended; 47 U.S.C. 151, 154(i), 154(j), 201-205, and 403, unless otherwise noted.

2. Section 61.3 is amended by redesignating paragraphs (p) through (ll) as (q) through (mm), and by adding a new paragraph (p) to read as follows:

§ 61.3 Definitions.

*****

(p) *GDP Price Index* (GDP-PI). The estimate of the "Fixed Weight Price Index for Gross Domestic Product, 1987 Weights" published by the United States Department of Commerce, which the Commission designates by Order.

3. Section 61.45 is amended by revising paragraphs (b) and (c), the introductory portions of paragraphs (d) and (d)(1), paragraphs (d)(1)(ii), (d)(1)(vi), and (e) to read as follows:

§ 61.45 Adjustments to the PCI for Local Exchange Carriers.

*****

(b) Adjustments to local exchange carrier PCIs for the baskets designated in § 61.42(d)(2), (3) and (4) shall be made pursuant to the formula set forth in § 61.44(b), and as further explained in §§ 61.44(e), (f), (g), and (h).

(1) Notwithstanding the value of X defined in § 61.44(b), the X value applicable to the baskets specified in § 61.42(d)(2) and (3) shall be 4.0%, or 4.7%, or 5.3%, as the carrier elects.

(2) For the basket specified in § 61.42(d)(4), the value of X shall be 3.0%, or 3.7%, or 4.3%, as the carrier elects.

(c) Subject to paragraph (e) of this section, adjustments to local exchange carrier PCIs for the basket designated in § 61.42(d)(1) shall be made pursuant to the following formula:

$$PCI_t = PCI_{t-1}[1+w[(GDP\text{-}PI - X - (g/2))/(1 + (g/2))] + \Delta Z/R]$$

where

GDP-PI = the percentage change in the GDP-PI between the quarter ending six months prior to the effective date of the new annual tariff and the corresponding quarter of the previous year,

X = productivity factor of 4.0%, or 4.7%, or 5.3% if the carrier so elects,

g = the ratio of minutes of use per access line during the base period, to minutes of use per access line during the previous base period, minus 1,

ΔZ = the dollar effect of current regulatory changes when compared to the regulations in effect at the time the PCI was updated to PCI_{t-1}, measured at base period level of operations,

R = base period quantities for each rate element "i", multiplied by the price for each rate element "i" at the time the PCI was updated to PCI_{t-1},

w = R + ΔZ, all divided by R,

PCI_t = the new PCI value, and

PCI_{t-1} = the immediately preceding PCI value.

(d) The exogenous cost changes represented by the term "ΔZ" in the formula detailed in paragraphs (b) and (c) of this section shall be limited to those cost changes that the Commission shall permit or require by rule, rule waiver, or declaratory ruling.

(1) Subject to further order of the Commission, those exogenous changes shall include cost changes caused by:

*****

(ii) Such changes in the Uniform System of Accounts, including changes in the Uniform System of Accounts requirements made pursuant to § 32.16, as the Commission shall permit or require be treated as exogenous by rule, rule waiver, or declaratory ruling.

*****

(vi) Such tax law changes and other extraordinary cost changes as the Commission shall permit or require be treated as exogenous by rule, rule waiver, or declaratory ruling.

*****

(e) The "w[(GDP-PI - X - [g/2))/(1+(g/2))]" component of the PCI formula contained in paragraph (c) of this section shall be employed only in the adjustment made in connection with the annual price cap filing.

7. Section 61.47 is amended by revising paragraphs (e), (g)(1), (g)(2), (g)(4), and (h)(2) to read as follows:

§ 61.47 Adjustments to the SBI; pricing bands.

*****

(e) Pricing bands shall be established each tariff year for each service category and subcategory within a basket. Except as provided in paragraphs (f), (g), and (h) of this section, each band shall limit the pricing flexibility of the service category or subcategory, as reflected in the SBI, to an annual increase of five percent or an annual decrease of ten percent, relative to the percentage change in the PCI for that basket, measured from the levels in effect on the last day of the preceding tariff year.

*****

(g)(1) *Local Exchange Carriers - Service Categories and Subcategories.* Local exchange carriers subject to price cap regulation as that term is defined in § 61.3(w) shall use the methodology set forth in paragraphs (a) through (d) of this section to calculate two separate subindexes: One for the DS1 services offered by such carriers and the other for the DS3 services offered by such carriers. The annual pricing flexibility for each of these two subindexes shall be limited to an annual increase of five percent or an annual decrease of ten percent, relative to the percentage change in the PCI for the special access services basket, measured from the last day of the preceding tariff year.

(2) The upper pricing band for the tandem-switched transport service category shall limit the annual upward pricing flexibility for this service category, as reflected in its SBI, to two percent, relative to the percentage change in the PCI for the trunking basket, measured from the levels in effect on the last day of the preceding tariff year. The lower pricing band

for the tandem-switched transport service category shall limit the annual downward pricing flexibility for this service category, as reflected in its SBI, to ten percent, relative to the percentage change in the PCI for the trunking basket, measured from the levels in effect on the last day of the preceding tariff year.

*****

(4) Local exchange carriers subject to price cap regulation as that term is defined in §61.3(v) shall use the methodology set forth in paragraphs (a) through (d) of this section to calculate a separate subindex for the 800 data base vertical features offered by such carriers. The annual pricing flexibility for this subindex shall be limited to an annual increase of five percent or an annual decrease of ten percent, relative to the percentage change in the PCI for the traffic sensitive basket, measured from the last day of the preceding tariff year.

*****

(h) ***

(2) The annual pricing flexibility for each of the subindexes specified in paragraph (h)(1) of this section shall be limited to an annual increase of five percent or an annual decrease of fifteen percent, relative to the percentage change in the PCI for the trunking basket, measured from the levels in effect on the last day of the proceeding tariff year.

12. Section 61.48 is amended by revising paragraphs (h)(3)(ii)(B), (h)(5)(i), (i)(3)(ii)(B), and (i)(4)(ii) to read as follows:

§ 61.48 Transition rules for price cap formula calculations.

*****

(h) ***

(3) ***

(ii) ***

(B) 0.90 times the SBI value for the special access services included in the category or subcategory on the day preceding the transport restructure date, weighted by the revenue weight of the transport services included in the category or subcategory.

*****

(5) ***

(i) The upper pricing band for the tandem-switched transport service category shall limit the upward pricing flexibility for this service category, as reflected in its SBI, to two percent, measured from the initial restructured rates for tandem-switched transport. The lower pricing band for the tandem-switched transport service category shall limit the downward pricing flexibility for this service category, as reflected in its SBI, to ten percent, measured from the initial restructured rates for tandem-switched transport.

*****

(i) ***

(3) ***

(ii) ***

(B) 0.85 times the SBI value for the services included in the zone category on the day preceding the later date, weighted by the revenue weight of the later services included in the zone category.

*****

(4) ***

(ii) From the later date through the end of the following tariff year, the annual pricing flexibility for each of the subindexes specified in paragraph (i)(4)(i) of this section shall be limited to an annual increase of five percent or an annual decrease of fifteen percent, relative to the percentage change in the PCI for the trunking basket, measured from the levels in effect on the last day of the tariff year preceding the tariff year in which the later date occurs.

*****

APPENDIX C

STATISTICAL DATA

Table 1

Digital Switches

(from ARMIS 4307)

Description	1989	1990	1991	1992	1993
Total Switching Entities	14,840	14,996	16,398	16,701	16,852
Total DSPC Switches	8,292	9,609	11,523	12,739	13,732
Percent DSPC Switches	55.88	64.08	70.27	76.28	81.49
Total Access Lines	110,036	113,735	123,022	125,778	129,642
Total DSPC Lines Served	46,704	55,428	64,873	73,815	85,543
Percent DSPC Lines Served	42.44	48.73	52.73	58.69	65.98

Table 2

Switches Equipped with SS7-394 (InterLATA) Capabilities

(from ARMIS 4307)

Description	1989	1990	1991	1992	1993
Total Switching Entities	14,840	14,996	16,398	16,701	16,852
Total Switches Equipped with SS7-394	7	212	1,248	5,753	8,037
Percent Switches Equipped with SS7-394	0.05	1.41	7.61	34.45	47.69
Total Access Lines	110,036	113,735	123,022	125,778	129,642
Total Lines with Access to SS7-394	31	3,799	23,377	71,151	96,128
Percent Lines with Access to SS7-394	0.03	3.34	19.00	56.57	74.15

Table 3

Switches Equipped with SS7-317 (IntraLATA) Capabilities

(from ARMIS 4307)

Description	1989	1990	1991	1992	1993
Total Switching Entities	14,840	14,996	16,398	16,701	16,852
Total Switches Equipped with SS7-317	917	2,578	4,091	7,487	8,845
Percent Switches Equipped with SS7-317	6.18	17.19	24.95	44.83	52.49
Total Access Lines	110,036	113,735	123,022	125,778	129,642
Total Lines with Access to SS7-317	19,392	43,022	62,199	86,176	102,208
Percent Lines with Access to SS7-317	17.62	37.83	50.56	68.51	78.84

Table 4

RBOC Investment and Operating Data 1/
(Dollar amounts shown in Thousands)

	1988	1989	1990	1991	1992	1993	% Change From 1988-90 to 1991-93
Plant Added During the Year							
Land and Support Assets	$2,408,531	$2,371,599	$2,572,178	$2,428,708	$2,639,043	$2,364,094	1.1%
Central Office Switching	4,103,566	3,501,703	3,631,402	3,501,953	3,474,221	3,535,551	-6.5%
Central Office Transmission	3,222,835	2,882,158	3,064,381	3,319,417	3,345,956	3,741,017	13.5%
Cable & Wire Facilities	3,996,239	4,011,283	4,662,223	4,595,253	4,550,068	4,548,257	8.1%
Other	608,508	541,452	582,852	703,691	632,406	684,363	16.6%
Total Additions to Plant In Service	14,339,679	13,308,195	14,513,036	14,549,022	14,641,694	14,873,282	4.5%
Depreciation and Amortization Expense	13,646,937	13,860,101	13,931,515	13,499,778	13,822,882	14,244,514	0.3%
Total Employee Compensation	16,852,136	16,913,401	17,237,406	17,484,524	17,157,988	17,955,026	3.1%
Total Access Lines	100,994,477	103,656,590	107,392,188	112,554,986	114,989,650	122,369,426	12.1%
Investment Trends							
New Investment as a percentage of Depreciation	105.1%	96.0%	104.2%	107.8%	105.9%	104.4%	4.2%
New investment as a percentage of Total Compensation	85.1	78.7	84.2	83.2	85.3	82.8	1.4%
New investment per access line	142	128	135	129	127	122	-6.8%

1/ Data from Statistics of Communications Common Carriers

Table 5

Local Exchange Carriers
Rate of Return Summary From
October 1985 to December 1994
(Dollar amounts shown in millions)

Company	Oct. 1, 1985 – Dec. 31, 1986		Jan.1, 1987 – Dec. 31, 1988		Jan. 1, 1989 – Dec. 31, 1990	
	AVG NET INV (see note 1)	ROR	AVG NET INV (see note 1)	ROR	AVG NET INV (see note 1)	ROR
Ameritech	$2,924	12.65%	$3,027	11.44%	$3,000	12.21%
Bell Atlantic	$3,628	12.45%	$3,850	12.35%	$3,991	11.11%
BellSouth	$4,676	11.99%	$4,771	12.75%	$4,717	12.14%
Nynex	$4,147	10.78%	$4,272	12.01%	$4,284	11.10%
Pacific Tel	$2,869	13.15%	$2,877	13.16%	$2,599	12.74%
Southwestern	$3,545	12.71%	$3,367	12.32%	$3,217	11.73%
U S West	$4,029	12.77%	$3,893	12.64%	$3,704	12.75%
Centel	$351	12.80%	$360	13.31%	$371	12.06%
Contel	$448	13.20%	$682	12.80%	$809	11.95%
Cincinnati	$116	11.23%	$122	14.07%	$131	11.52%
GTE	$3,511	12.49%	$3,804	11.59%	$3,722	11.55%
Rochester	$89	12.25%	$117	12.46%	$126	10.72%
SNET	$440	12.08%	$496	11.86%	$510	12.02%
United	$1,012	12.50%	$1,035	13.04%	$1,042	12.26%
Lincoln	NA	NA	$61	12.29%	$58	11.51%
Total	$31,785	12.33%	$32,734	12.34%	$32,281	11.88%
Authorized ROR		12.75%		12.00%		12.00%

Table 5
page 2

Local Exchange Carriers
Rate of Return Summary From
October 1985 to December 1994
(Dollar amounts shown in millions)

Company	Jan. 1, 1991 – Dec. 31, 1991		Jan. 1, 1992 – Dec. 31, 1992		Jan. 1, 1993 – Dec. 31, 1993		Jan. 1, 1994 – Dec. 31, 1994 Preliminary Form 492	
	AVG NET INV (see note 2)	ROR	AVG NET INV (see note 2)	ROR	AVG NET INV (see note 1)	ROR	AVG NET INV (see note 1)	ROR
Ameritech	$2,935	13.00%	$3,006	12.79%	$2,998	14.80%	$2,919	13.05%
Bell Atlantic	$3,995	12.71%	$4,025	12.50%	$3,986	14.01%	$4,002	14.19%
BellSouth	$4,652	12.62%	$4,640	12.80%	$4,631	13.68%	$4,577	15.75%
Nynex	$4,223	9.35%	$3,947	12.50%	$3,835	12.55%	$3,706	11.82%
Pacific Tel	$2,465	11.89%	$2,475	12.73%	$2,520	13.01%	$2,491	15.15%
Southwestern	$3,188	10.75%	$3,080	11.80%	$3,103	12.91%	$3,168	13.25%
U S West	$3,646	12.40%	$3,621	12.41%	$3,564	13.62%	$3,698	12.36%
Centel	NA	NA	NA	NA	$321	14.05%	$326	16.93%
Contel (see note 3)	$534	15.53%	$819	10.06%	$804	15.79%	NA	NA
Cincinnati	NA	NA	NA	NA	NA	NA	NA	NA
GTE (see note 3)	$3,751	11.99%	$3,745	11.47%	$3,684	9.79%	$3,747	12.84%
Rochester	$80	11.82%	$184	12.27%	$202	13.75%	$196	14.71%
SNET	$128	8.86%	$507	12.90%	$498	11.52%	$495	11.34%
United	$1,027	13.06%	$1,011	12.75%	$990	13.68%	$994	16.96%
Lincoln	NA	NA	NA	NA	$52	14.95%	$49	15.52%
Total	$30,624	11.91%	$31,060	12.34%	$31,188	13.12%	$30,367	13.70%
Benchmark ROR		11.25%		11.25%		11.25%		11.25%

Notes:

1 Industry Analysis Division Rate of Return Summary, FCC Form 492.
Centel, United, GTE and Contel rates of return are FCC generated.

2 USTA data dated Oct 17, 1994. USTA indicates that Centel and Lincoln's avg net inv represents one half the amount shown in the Form 492 because they became price cap LECs 7/1/93. This is also the case for Rochester and SNET for 1991.

3 For 1994, GTE and Contel's data are provided on an aggregated basis.

Table 6

	1991	1992	1993	1994	Total
Total rate impact by year -- the difference between actual rates and those in effect in 1990					
COMMON LINE	(430,999,530)	(861,329,177)	(628,406,252)	(470,907,382)	(2,391,642,341)
TRAFFIC SENSITIVE	(186,946,186)	(363,292,373)	(978,930,125)	(914,157,104)	(2,443,325,788)
SPECIAL ACCESS/TRUNKING	(38,376,988)	(48,325,469)	(213,104,184)	(705,497,586)	(1,005,304,227)
INTEREXCHANGE	(5,725,506)	(17,314,197)	(24,689,709)	(30,698,425)	(78,427,837)
TOTAL INTERSTATE ACCESS	(656,322,704)	(1,272,947,019)	(1,820,440,561)	(2,090,562,072)	(5,840,272,356)
TOTAL INTERSTATE	(662,048,210)	(1,290,261,216)	(1,845,130,270)	(2,121,260,497)	(5,918,700,193)
Exogenous cost by calendar year (excluding sharing and LFAM)					
COMMON LINE	(461,857,840)	(160,541,158)	1,154,308,129	41,325,216	573,234,348
TRAFFIC SENSITIVE	(310,415,636)	(208,543,649)	(747,080,784)	(4,404,955)	(1,270,445,024)
SPECIAL ACCESS/TRUNKING	(37,349,417)	(18,459,870)	(238,854,079)	(5,271,281)	(299,934,647)
INTEREXCHANGE	153,943	(137,766)	1,425,493	(637,207)	804,463
TOTAL INTERSTATE ACCESS	(809,622,893)	(387,544,676)	168,373,266	31,648,980	(997,145,322)
TOTAL INTERSTATE	(809,468,950)	(387,682,442)	169,798,759	31,011,773	(996,340,859)
Cumulative for year	(809,468,950)	(1,197,151,392)	(1,027,352,633)	(996,340,859)	(4,030,313,834)
Revenues below Cap -- the difference between PCI and API Revenues					-
COMMON LINE	3,747,480	45,239,180	196,929,845	309,944,299	555,860,803
TRAFFIC SENSITIVE	7,616,461	41,764,776	123,064,989	114,487,465	286,933.691
SPECIAL ACCESS/TRUNKING	19,123,056	42,038,051	54,059,515	126,165,960	241,386,582
INTEREXCHANGE	4,722,307	14,486,507	19,890,728	19,891,979	58,991,521
TOTAL INTERSTATE ACCESS	30,486,997	129,042,007	374,054,349	550,597,724	1,084,181,076
TOTAL INTERSTATE	35,209,304	143,528,514	393,945,077	570,489,703	1,143,172,597
Sharing and LFAM -- combined amouts					
COMMON LINE	0	848,415	(21,152,300)	(49,537,159)	(69,841,044)
TRAFFIC SENSITIVE	0	17,782,283	(28,039,712)	(31,524,274)	(41,781,702)
SPECIAL ACCESS/TRUNKING	0	36,626,247	(526,899)	(68,469,778)	(32,370,430)
INTEREXCHANGE	0	(1,789,831)	(65,378)	(5,871,237)	(7,726,446)
TOTAL INTERSTATE ACCESS	0	55,256,945	(49,718,911)	(149,531,210)	(143,993,176)
TOTAL INTERSTATE	0	53,467,114	(49,784,288)	(155,402,448)	(151,719,622)
Inflation, productivity factors actually selected, and the effect of traffic growth on the calculation of CCL rates					
COMMON LINE	34,605,789	(194,539,415)	(942,233,238)	(684,660,272)	(1,786,827,137)
TRAFFIC SENSITIVE	131,085,911	179,649,405	438,214,645	502,299,659	1,251,249,619
SPECIAL ACCESS/TRUNKING	18,095,485	12,895,622	136,145,595	(210,927,202)	(43,790,499)
INTEREXCHANGE	(1,157,142)	(1,054,036)	(6,175,273)	(5,739,672)	(14,126,123)
TOTAL INTERSTATE ACCESS	183,787,185	(1,994,388)	(367,872,998)	(393,287,815)	(579,368,017)
TOTAL INTERSTATE	182,630,043	(3,048,424)	(374,048,272)	(399,027,487)	(593,494,140)

Source: USTA Ex Parte, February 28, 1995 and March 17, 1995.

APPENDIX D

RECALCULATION OF THE FRENTRUP-URETSKY STUDY EXCLUDING THE 1984/85 DATA POINT

by Alexander Belinfante and Mark Uretsky[1]

I. BACKGROUND AND CONCLUSIONS

As part of the Order establishing price caps for the LECs,[2] the Commission relied upon a short-run study (Frentrup-Uretsky study) of switched access productivity for the local exchange carriers.[3] That study was designed to determine the X-Factor that would have yielded the same trend of prices under the Commission's price-cap plan as was actually observed under rate-of-return regulation.

The short-run study took an observed trend of LEC access price data along with observed GNP-PI data and calculated the X-Factor that would have produced that trend, given the price-cap rules. The X-Factor computed by the short-run study, however, is not, strictly speaking, a productivity factor. Rather, the resulting factor combines productivity and input price information for the industry relative to the economy as a whole, to determine a cost differential between the LEC industry and the economy as a whole. Thus, it would be more appropriate to describe the X-Factor as a cost-differential factor rather than a productivity factor.

This appendix describes a staff study which makes a few technical revisions in the way the X-Factor was estimated and, more important, examines the impact of removing the controversial 1984/85 data point from the historical data used in the Frentrup-Uretsky study. No attempt is made here to update the data used in the study. This analysis is designed to determine the X-Factor that the original study would have produced if the Commission had decided to exclude that controversial data point. Thus, this analysis provides an independent estimate of MCI's claim that removal of this data point would increase the calculated X-Factor from this model by 2.0%.[4]

---

1 Mr. Belinfante is Senior Economist and Mr. Uretsky is Chief Economist, Common Carrier Bureau, Federal Communications Commission.

2 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786 (Second Report and Order).

3 Appendix C, "A Study of Local Exchange Carrier Post-Divestiture Switched Access Productivity," by J. Christopher Frentrup and Mark I. Uretsky, 5 FCC Rcd 6885.

4 MCI Comments, May 9, 1994, at 21.

At the time that the LEC price caps rules were adopted in 1990, there was much criticism of the inclusion of the 1984/85 data point.[5] Interested parties argued that the underlying data were unreliable due to the many changes that occurred as a result of AT&T's divestiture of its local exchange companies. Parties also submitted statistical analyses indicating that the data point was an anomalous "outlier". The Commission's position in 1990 was that the 1984/85 data point provided relevant information and should not be discarded. Subsequent experience, however, has convinced us that the critics were right, and the data point should have been excluded. We believe that the corrections we made to the 1984/85 data point in 1990 may have been insufficient to compensate for all of the disruptions caused by divestiture. Evidence provided by USTA's recent filings indicates that, using a TFP approach, with an adjustment for input prices, the X-Factor for the period 1984/85 to 1990 was 4.8%, which is close to our estimates that exclude the 1984/85 data point.[6] Furthermore, USTA's data show no unusual or out-of-trend growth for the 1984-1985 period, lending additional weight to the view that the 1984/85 data provided to the Commission in the original proceeding was erroneous and should be excluded. The high and growing rates of return experienced by the price cap LECs in recent years also provide evidence that the X-Factor was set too low and that the 1984/85 data was indeed out of line with subsequent experience.

Attachment A summarizes the X-Factors from the original study as compared with our revised estimates of the X-Factors both including and excluding the 1984/85 data point. The X-Factor of 3.5% that was originally estimated in the Frentrup-Uretsky study[7] (and used by the Commission to set the 3.3% X-Factor currently in use) has been re-estimated from the same data, but using a slightly revised methodology (described below) as 3.4%. Our estimate of this X-Factor using the same data but eliminating the 1984/85 data point is 5.0% (1.6% higher than our revised estimate including that data point).[8] This compares with the 5.47% estimate filed by MCI in their estimate of the impact of removing the 1984-/85 data point. The differences between their estimate and ours are due to differences in methodology and differences in the treatment of the 1990 data point.

---

5 These criticisms and the Commission's response to them are summarized in the Second Report and Order, CC Docket No. 87-313, at 6892-6894.

6 The estimate excluding 1984/85 using the TFP approach adjusted for input prices is 4.9%. See Appendix F, Attachment A, of this Order.

7 This is the unitary balanced 50/50 X-Factor, as explained below.

8 The original study also computed prospective X-Factors, based on trend projections and assumptions about future growth of CCL minutes per line (the g-factor). The prospective unitary balanced 50/50 X-Factor in the original study was 3.4%. Our revised estimates of this X-Factor are 3.6% including the 1984/85 data point and 5.5% excluding the data point. The assumptions about the future growth of the g-factor in the original study proved to be incorrect.